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NO. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee

On Appeal From The Supreme Court of Texas

AMICUS CURIAE BRIEF OF ARTHUR ANDERSEN & CO. IN SUPPORT OF THE APPEAL OF HOUSTON LIGHTING & POWER COMPANY

DAVID C. DUGGINS
CLARK, THOMAS, WINTERS
& NEWTON
P. O. Box 1148
Austin, Texas 78767

Attorney for
Arthur Andersen & Co.

Alpha Law Brief Co., Inc. — 8748 Westpark—Houston, Texas 77063 — 789-2000

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Arthur Andersen & Co. respectfully submits its Amicus Curiae brief in support of Appellant's appeal. Written consent of all parties to the filing of this brief has been obtained.

INTEREST OF AMICUS CURIAE

Arthur Andersen & Co. is one of the largest international independent public accounting firms with 226

offices located in 49 countries throughout the world, of which 80 are in the United States and 5 in Texas. Arthur Andersen audits approximately one-third of the electric and gas companies in the United States and a substantial portion of the telephone industry. As independent public accountants, Arthur Andersen believes that proper reporting to the public of financial information, including the effects of income taxes, is extremely important because of the potential effect on investment decisions. With respect to public utility companies, the reported financial information is affected to a significant degree by the ratemaking procedures applied to such utilities by regulatory commissions. Therefore, Arthur Andersen is vitally concerned about the matter before this Court.

Arthur Andersen & Co. urges the Court to note jurisdiction in order to review the decision of the Supreme Court of Texas that federal income tax savings related to expenses not included in cost of service should be used to reduce cost of service. Such tax savings are shareholder property and should not be used to reduce regulated cost of service. Review and reversal of the Texas court's action is necessary to avoid confiscation of shareholder property, violation of fundamental accounting principles, and a probable violation of the Internal Revenue Code.

SUMMARY OF ARGUMENT

The ability to reduce taxes is one of the characteristics of property. This Court recognizes that the ability to reduce taxes has value. Generally accepted accounting principles recognize the value of and asset characteristics of tax benefits.

Simple fairness dictates that tax benefits follow the asset or expense which gave rise to the benefits. This proper allocation is the preponderant regulatory practice, and is consistent with generally accepted accounting principles and the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) and adopted by the Public Utility Commission of Texas ("Texas Commission"). The precedent upon which the Texas Supreme Court relied, principally the *United Gas* decision of this Court, is obsolete due to accounting, regulatory, and legal changes subsequent to that decision.

In this case, the expense, $166,000,000 in abandonment cost, which gave rise to the tax benefit was disallowed from rates by the Commission and thus borne by the shareholders. The tax benefit derived from that expense has value and belongs to the shareholder. The Texas Supreme Court's decision to give this asset, the tax benefit, to the ratepayers confiscates shareholder property and, in all likelihood, violates the normalization provisions of the Internal Revenue Code.

ARGUMENT AND AUTHORITIES

I.

CHARACTERISTICS OF PROPERTY

Generally Accepted Accounting Principles

Property has two inherent characteristics. One is the ability of an asset to generate revenues and the second is the ability of the asset to reduce income taxes. Statement of Fnancial Accounting Concepts No. 6, issued December 1985 by the Financial Accounting Standards

Board (FASB),[1] refers to these characteristics as "service potential" or "future economic benefit".

The Accounting Principles Board, predecessor board to the FASB, and the FASB discussed the value associated with the reduction in taxes in pronouncements affecting the accounting for business combinations. Accounting Principles Board (APB) Opinion No. 16 (issued August 1970) states:

> Estimated future tax effects of differences between the tax bases and amounts otherwise appropriate to assign to an asset or liability are one of the variables in estimating fair value. Amounts assigned to identifiable assets and liabilities shall, for example, recognize that the fair value of an asset to an acquirer is less than its market or appraisal value if all or a portion of the market or appraisal value is not deductible for income taxes.

Additionally, Statement of Financial Accounting Standards (SFAS) No. 38, (issued September 1980), paragraph 5, provides the accounting for the potential tax benefit of a loss carryforward of a purchased subsidiary. If the utilization of the tax benefits is assured beyond any reasonable doubt, this pronouncement provides for the tax loss carryforward to be recorded as an asset.

Statement of Financial Accounting Standard No. 96 (issued December 1987) modified the accounting for tax

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1. The Financial Accounting Standards Board was established in 1973 as the successor board to the Accounting Principles Board. This board is the authoritative body with regard to accounting principles. The Securities and Exchange Commission in Accounting Series Release No. 150 dated December 20, 1973 reaffirmed that the FASB will be considered to be substantial authoritative support and accounting practices contrary to FASB pronouncements will be considered to have no such support.

benefits related to purchases described in APB Opinion No. 16 and SFAS No. 38, but continued to acknowledge that the tax benefits did affect the value of an asset and that tax benefits have some of the characteristics of assets.

Applicable Law

This Court has recognized that ability to reduce taxes is an asset. In *Cascade Natural Gas Corporation v. El Paso Natural Gas Company*, 386 U.S. 169 (1967), the Court found that the pre-merger tax losses of Pacific Northwest (the company acquired and then spun off) which were used by El Paso Natural Gas Company (the acquirer) after the merger but prior to spin-off were of value and required remuneration. It was argued that the tax loss carryovers were in a real sense an asset of Pacific Northwest, the new company, and it should receive other assets or a reduction in debt of an equivalent value. The Court found that "these allegations, if proven, require remuneration of some kind to the new company." Based on the *Cascade* case, Houston Lighting & Power's tax deductions associated with abandonment of Allen's Creek are clearly an asset of which the company may not be deprived without compensation.

II.

PROPERTY AND EXPENSE EXCLUDED FROM RATES IS NON-UTILITY

Houston Lighting & Power Co. commenced planning work in the early 1970's for the construction of Allen's Creek Nuclear Station. In 1982, the company decided to abandon the Allen's Creek project. Thus,

Allen's Creek would never be used in rendering electric utility service as a utility plant. Allen's Creek costs could only be utility property to the extent allowed by the Texas Commission. The Uniform System of Accounts of the FERC, 18 C.F.R. 101 (1987), which has been adopted by the Texas Commission, 16 Tex. Admin. Code § 23.12(a)(2)(B)(i) (1986), recognizes that a commission may allow recovery of abandonment costs. Account 407, "Amortization of Property Losses, Unrecovered Plant, and Regulatory Study Costs" allows for costs to be charged to this utility account " . . . when the Commission has authorized the amount . . ." of unrecovered Plant and Regulatory Study Costs " . . . to be amortized by charges to electric operations." The non-utility nature of abandonment costs not allowed to be recovered through rates is provided for in account 426.5, "Other Deductions" which provides "this account shall include other miscellaneous expenses which are non-operating in nature. . . ." Items included in the account 426.5 description include abandonments not allowed to be written off to account 407. The Allen's Creek abandonment costs are utility costs only to the extent allowed by the Texas Commission. The amounts disallowed by the Texas Commission are non-utility costs and the responsibility of the shareholder.

III.

TAX BENEFITS FOLLOW THE ASSET OR EXPENSE

Preponderant Regulatory Practice

Under the standard ratemaking practice in Texas and all other regulatory jurisdictions in the United States,

revenue requirements are set to allow a public utility the opportunity to recover all of its costs, including income taxes, plus a return on its unrecovered investment in public utility property. If a cost is disallowed for ratemaking purposes, one would expect that the effect of the disallowance would be to leave revenue requirements at the same amount as if the disallowed cost had not been incurred. To illustrate, (1) assume that operating expenses, including depreciation and taxes, of a utility are $30,000,000. This amount would be included in revenue requirements collectible from ratepayers. (2) Assume further that $1,000,000 of additional expenses are incurred and allowed for ratemaking purposes. Revenue requirements would increase by $1,000,000, to $31,000,000. (Since both taxable revenues and tax-deductible expenses would increase by $1,000,000, these would have no effect on taxable income or income tax expense.) (3) Assume further that the regulator disallows the $1,000,000 of expenses for ratemaking purposes. It would be expected that the revenue requirements related to operating expenses would remain at $30,000,000. However, the action of the Texas Commission, as upheld by the Supreme Court of Texas, would reduce operating expenses in the revenue requirements to approximately $29,148,000 (at the 46% Federal Income Tax rate then in effect) because the tax benefit of the $1,000,000 was given to the ratepayer without the burden of the associated expense. As a result, ratepayers would receive a windfall and the utility would recover less than the $30,000,000 of its allowed operating expenses, thereby confiscating shareholder property. In the case at bar, the windfall was $111,000,000.

The preponderant practice of federal and state regulatory commissions, including the FERC and the Texas Commission, is greatly at odds with the decision of the Texas Commission upheld by the Texas Supreme Court in this case. The prevailing practice of these agencies is to require that tax expense (both positive and negative) be "synchronized" or "normalized" by allocating the expense between operating expenses allowed for ratemaking purposes and those disallowed for ratemaking purposes.

Both FERC and the Texas Commission have recognized that tax recovery should be allowed on an allocated (normalized) basis. The Texas Commission's Substantive Rule 23.21 (b)(1)(D), 16 Tex. Admin. Code § 23.21(b)(1)(D) (1986), allows, as a component of the cost of service, "Federal income taxes on a normalized basis." The FERC in Order 144, 46 Fed. Reg. 26613 (May 1981), concluded that "tax normalization more appropriately comports with sound regulatory principle and with the public interest. . . ." In Order 144, page 22, the FERC states that "The central rationale for tax normalization is that tax normalization matches the recognition in rates of the tax effects of the costs and revenues to the recovery in rates of the associated costs and revenues themselves." FERC succinctly stated the point of taxes following the expenses on page 37 of Order 144: "Tax normalization synchronizes the recognition in rates of the expense itself." Order 144 was affirmed in *Public Systems v. F.E.R.C.*, 709 F.2d 73 (D.C. Cir. 1983).

The Supreme Court of Texas has upheld a reduction of incurred income tax expense *applicable* to Utility Operations through use of income tax deductions *not applicable* to Utility Operations. This is clearly contrary to the required synchronization of tax normalization as prescribed by both the FERC and the Texas Commission.

Discussing regulatory allocation of tax expense, the California Public Utilities Commission stated:

> The Commission has consistently calculated income taxes for ratemaking purposes based on the cost of service developed from adopted expenses, which excludes the various disallowed expenses. This method results in adopted income taxes higher than otherwise, because the disallowed expenses are not included as tax deductions. Both the staff and the Industry recommend that the present practice continue. . . . We agree with staff and Industry that the present method of treating these costs is reasonable and should be continued. . . .

Re Income Tax Expense for Ratemaking Purposes, 59 P.U.R. 4th 576, 582-83 (1984).

This preponderant regulatory practice of tax effects following the asset is also clearly demonstrated in the divestiture of American Telephone and Telegraph (AT&T). Customer Premise Equipment (CPE) was transferred to unregulated AT&T from the regulated regional Bell holding companies. The Federal Communication Commission (FCC) determined that, to comply with the plan of reorganization, *see United States v. Western Electric Co., Inc.*, No. 82-0192 (D. Dist. Col., December 16, 1982). it was appropriate for the accumulated deferred taxes and investment tax credits associated with the CPE be transferred to AT&T and be unregulated. *Matter of Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry),* F.C.C. Docket No. 83-551 (November 23, 1983).

The Texas Commission agreed with the FCC and in its Docket No. 5220 allowed the CPE and related de-

ferred taxes and investment tax credits to be transferred from Southwestern Bell Telephone Company to AT&T. *Re Southwestern Bell Application to Increase Rates*, P.U.C. Docket 5220 (May 19, 1984).

Uniform System of Accounts

The regulator must determine what revenues and expenses (including incurred income tax expense) are applicable to utility operations of the regulated entity. When the regulator sets rates for an entity based on less than all of its revenues and expenses, the related income tax expense must also be allocated between regulated utility operations and other activities. This allocation recognizes that the tax effects should be matched with the related expense or income giving rise to the taxes. The method for determining this allocation is set forth in the Uniform System of Accounts. 18 C.F.R. 101 (1987). Separate accounts are provided for income taxes related to "utility operating income" (Accounts 409.1, 410.1, 411.1) and "other income and deductions" (Accounts 409.2, 410.2, 411.2). Utility operating income refers to revenues and expenses allowed for ratemaking purposes; other income and deductions refers to revenues and expenses disallowed or considered nonregulated for ratemaking purposes.

The instructions for these accounts state that the ". . . accruals for income taxes shall be apportioned among utility departments and to Other Income and Deductions so that, as nearly as practicable, each tax shall be included in the expenses of the utility department or Other Income and Deductions, the income from which gave rise to the tax." The instructions for account 409.1, Income Taxes, Utility Operating Income, state that this

". . . account shall be maintained so as to allow ready identification of tax effects (both positive and negative) relating to Utility Operating Income . . ." The instructions for account 409.2, Income Taxes, Other Income and Deductions, state that this ". . . account shall include the amount of . . . income taxes (both positive and negative), which relate to Other Income and Deductions." Since the Allen's Creek costs disallowed by the Texas Commission are reported as Other Deductions, the tax consequences of those costs should be reported in account 409.2.

However, the Supreme Court of Texas's decision would effectively require the taxes applicable to the disallowed expenses to be reported as a negative component of Income Taxes, Utility Operating Income. This is a clear violation of the Public Utility Commission's own rules, as well as the Uniform System of Accounts adopted by those rules.

IV.

THE TEXAS SUPREME COURT RELIED ON OBSOLETE PRECEDENTS

The Supreme Court of Texas, in reaching its decision, relied on this Court's decision in *Federal Power Comm'n v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967). In that case, this Court allowed the Federal Power Commission (FPC) to offset the taxable losses of unregulated affiliates, to the extent that the losses exceed taxable income of unregulated affiliates, against utility taxable income for determining income tax expense for rate purposes, in effect passing on the tax benefits of losses of unregulated affiliates to ratepayers. This Court did not rule that this approach was the only approprate

methodology, but found merely that the FPC's method of allocating taxes "did not exceed the powers granted to it by Congress." *Id.* at 243. Neither the confiscation question at issue here nor any other constitutional question was raised or decided in *United.*

Subsequent to the *United* decision of 1967, however, a number of events have occurred with respect to using the tax benefits of expenses not included in cost of service for purposes of reducing the taxes included in cost of service which render the tax treatment in the *United* decision obsolete.

1. In December, 1967, the American Institute of Certified Public Accountants (AICPA) Accounting Principles Board adopted Opinion No. 11 which prescribed the normalization method of income tax accounting.

2. In 1969, Congress became concerned that tax reductions created by the use of accelerated tax depreciation instead of straight-line depreciation were being flowed-through to ratepayers immediately. Such flow-through reduced Treasury revenues and was contrary to the Congressional intent manifested in its enactment of accelerated depreciation in 1954. The intent of accelerated depreciation was to encourage the modernization of the nation's productive facilities by reducing the cost of financing new additions, not to achieve an immediate decrease in utility rates. To achieve its intent, Congress revised the Internal Revenue Code in 1969, which provisions were strengthened in 1971, 1981, 1982 and 1986, to state that a public utility company cannot use accelerated tax depreciation unless the utility is subject to the normalization method for ratemaking purposes. 26 U.S.C.A. §§ 167(e), 168(i)(9) (Supp. 1988) [formerly 168(e)(3)]. The normalization method requires that in-

come tax expense allowed for ratemaking purposes be "matched" to depreciation expense allowed for ratemaking purposes. The Texas Supreme Court in this case violated the matching inherent in normalization by permitting the Commission to compute allowed income tax expense for ratemaking purposes by the use of deductions generated by expenses which were disallowed for ratemaking purposes. There is a distinct possibility, discussed *infra,* that this violation of the normalization rules will result in Appellant being ruled ineligible for accelerated depreciation by the Internal Revenue Service (IRS), with immediate adverse effect on its stockholders and ratepayers.

3. The FPC, in 1969, amended its Uniform System of Accounts to require that income taxes (both positive and negative) applicable to non-regulated or other "below the line" costs should be allocated "below the line." Order 389, 34 Fed. Reg. 17436 (October 1969).

4. The FPC, in 1972, adopted a tax allocation method contrary to the method it used in the *United* case. In *Florida Gas Transmission Company,* 93 P.U.R. 3d 477, 496 (1972), the FPC stated:

> In our opinion a utility should be regulated on the basis of its being an independent entity; that is a utility should be considered as nearly as possible on its own merits and not on those of its affiliates.

5. The FPC, in 1977, continued the tax allocation method used in *Florida Gas,* and specifically referred to its earlier *United* decision:

> In the *United* case the commission had proceeded on the thesis that "tax losses" from nonjurisdic-

> tional activities of a company are to be considered in fixing the income tax allowance for jurisdictional activities. This approach was subjected to reevaluation in Florida Gas, and, as an alternate ground for decision in that case, the commission determined that utilities should henceforth be considered as separate entities for the ratemaking purpose of determining their costs of providing jurisdictional service. . . . Consequently, cities' reliance upon Cities Service and United is misplaced, the rationale underlying those decisions being no longer persuasive for ratemaking purposes. . . . [I]t would be difficult to justify the appropriation of any tax savings . . . by the jurisdictional consumers when these same consumers did not pay the expenses which created the deductions for tax purposes.

Southern California Edison Co., 23 P.U.R. 4th 44 (1977).

6. More recently, the U.S. Court of Appeals, D.C. Circuit, upheld the FERC's continued application of separate entity, stand alone ratemaking methodology. *City of Charlottesville v. F.E.R.C.*, 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied,* 106 S. Ct. 1515 (1986).

Changes and events subsequent to the *United* case have rendered the FPC's tax treatment in that decision obsolete. Accordingly, the Texas Supreme Court's reliance on that case as authority for its decision is unjustified.

V.

PROBABLE VIOLATION OF INTERNAL REVENUE CODE AND REGULATIONS

As stated earlier, Congress has set limitations on the right of public utility companies to deduct accelerated tax depreciation where rate regulation was inconsistent with the "normalization" method.

Based on the Internal Revenue Code and related Regulations, it is probable that the Texas Commission's reduction in income tax expense in cost of service reflecting the tax benefit from disallowed expenses would be held by the IRS to constitute a violation. This is because income tax expense in cost of service would be less than required by the IRS rules for normalization. Based on several private letter rulings from the IRS,[2] it is quite clear that it is a violation to use tax losses from unregulated activities to reduce regulated cost of service. (The disallowance of part of the cost of Allen's Creek project has the effect of passing such disallowed costs to the Company's shareholders, thus effectively removing such costs from regulation.)

For example, in Private Letter Ruling No. 86-43052, issued July 29, 1986, the IRS concluded that a taxpayer will not be in compliance with the normalization requirements if, in computing its income tax expense for ratemaking purposes, such tax expense is reduced by the tax effects attributable to the income tax losses of other entities. The IRS stated:

> . . . the use of tax benefits attributable to other entities in the determination of deferred tax expense or current tax expense will cause Taxpayer to fail to comply with the normalization provisions of the Code and the regulations thereunder. . . . Taxpayer will not be in compliance with the normalization requirements of Sections 167(1) and 168(e)(3) of the Code, if, in computing its total expense for purposes of establishing its cost of service for rate-

2. For example, PLR 86-43052, 87-11050, 88-01041. Even though private letter rulings are technically directed to the taxpayer requesting the ruling, they reflect the thinking of the IRS on any given issue.

making purposes, its current tax expense is reduced by a portion of the tax savings attributable to the tax losses of Loss Subsidiaries.

The IRS also ruled that consistency is required with respect to assumptions used in calculating income tax expense, depreciation expense, deferred taxes, and rate base. The IRS noted that, in the above-cited situation, the losses of the subsidiaries are being used to calculate income tax expense; however, none of the loss entities' assets are included in rate base and the depreciation of the loss entities' assets is not being considered in calculating the taxpayer's depreciation expense. A lack of consistency would also cause a normalization violation to occur.

The loss of accelerated tax deductions resulting from this violation would severely reduce cash flow to the utility through the elimination of the cost-free capital provided by this tax incentive. The necessary replacement capital would greatly increase the revenue requirements which must be collected from future ratepayers.

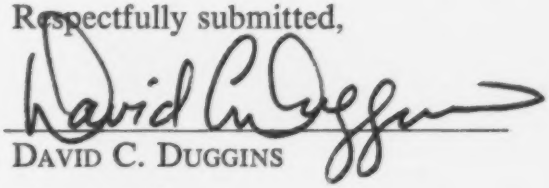
CONCLUSION

From an accounting standpoint, the Texas Supreme Court's decision on the tax issue herein discussed is simply wrong. Since the accounting fundamentals which are violated by the Texas Supreme Court's decision are part of the substantive rules of the Texas Commission, the decision is wrong from a legal standpoint. From the standpoint of simple fairness, it appears to *amicus* that, assuming an expense to be imprudent, the regulatory goal should be to place ratepayers in the same position they would have held had the expense never been incurred.

By both disallowing the expense and crediting ratepayers with the tax savings generated by the expense, the Texas Supreme Court decision places ratepayers in a better position than they would have been had the expense never occurred, since a nonexistent expense would obviously not generate a tax savings.

The Texas Supreme Court's decision upholds penalizing the utility's equity owners, confiscates shareholders' assets, and grants a windfall to its ratepayers. This windfall will be short-lived, however, since the decision will probably result in Appellant's loss of the benefits of accelerated tax depreciation, thereby inevitably increasing rates. The decision is justified by neither principles of accounting, the applicable law, nor by simple fairness. This Court should note jurisdiction and reverse, to correct the improper treatment and resulting confiscation of shareholder tax benefits.

Respectfully submitted,



DAVID C. DUGGINS

Attorney for
Arthur Andersen & Co.

Of Counsel:

CLARK, THOMAS, WINTERS & NEWTON
P. O. Box 1148
Austin, Texas 78767

PROOF OF SERVICE

I, David C. Duggins, Attorney for Arthur Andersen & Co., Amicus Curiae herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 29 day of July, 1988, I served copies of the foregoing Amicus Curiae Brief of Arthur Andersen & Co. on the parties hereto, said copies being mailed to:

Karen Pettigrew
Assistant Attorney General
ATTORNEY GENERAL'S OFFICE
14th and Colorado, SCB
P. O. Box 12548, Capitol Station
Austin, TX 78711-2548
Attorney for Appellee

Edgar M. Roach, Jr.
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27602
Attorney for Appellants

David C. Duggins

DAVID C. DUGGINS